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Arindam Banerjee

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International Outsourcing Hurdles in Value-added Services

Arindam Banerjee
Indian Institute of Management, Ahmedabad

Abstract

Purpose: International Outsourcing has been traditionally looked upon as a low end cost effective servicing option to take advantage of the cost arbitrage that exists across countries. Of late, many outsourcing vendors have realized that the advantages of cost differentials that spurred a lot of the global outsourcing business in the past 20 years will disappear in the medium term. This paper provides a perspective about how much value addition, besides cost, traditional outsourcing vendors can provide and what may be the facilitator/ inhibitors of such activities.

Approach: To substantiate the claim, a brief case describing the setting up of an offshore analytics operation is presented which gives a back drop to the challenges faced in relatively high end value creation processes in a remote outsourced environment.

Findings/Claim: The author uses the case to develop a conceptual model of off shoring value – added services. The key dimensions that will determine the extent to which international outsourcing of high end services will take place are: 1) Expertise of the vendor, 2) Environmental Stability of the Outsourcing Domain, 3) Physical Barriers to outsourcing complex business processes such as, Communication Problems and Proximity issues, 4) Possibility of Knowledge Leakage from Outsourcing Domain and, 5) Cost Benefits of Outsourcing.

Practical Implications: The author contends that conventional outsourcing vendors may find it difficult to acquire “Expert Power” and, set aside negative perceptions of “Environmental Stability” of their domain, in the pursuit to climb up the value chain in their client organizations. The validation of the proposed model is an opportunity for future research.

Originality: This paper is one of the first to present a model that will govern the growth of international outsourcing opportunities in high end value-added processes.

Key words: International Outsourcing, Offshoring, Value addition, competitive advantage.

Article Type: Conceptual Paper

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The conventional definition of outsourcing is to buy a service from an agency which, is beyond the managerial/control perimeter of one's own organization on an ongoing basis for a transaction fee. The "intellectual" property rights to the service provided may be negotiated in ways which differ based on the nature of the service provided and, the degree of customization added for the Principal. For instance, generic services required by many clients and, which are provided by many outsourced vendors (Agents), have very little differentiation to make property rights an important bone of contention. Value in such a context, is not commanded by the quality of a service provided, but by the speed with which it is provided at the lowest possible cost. Conventional wisdom would categorize such activities as routine process outsourcing that is merely taking advantage of the cost arbitrage across geographies.

Such global reassignment of work to take advantage of cost arbitrage issues has been in the works for a long time, although it has gained impetus and political visibility in the past 15-20 years. However, more importantly, what was earlier considered to be a differentiator on the cost parameter has by now been relegated to a hygiene factor for all global organizations. A primary reason for this relegation has been the "routineness" of the processes that have been relocated to low cost countries and the surfeit of talent in those countries who have seamlessly acquired the skills required to deliver such services at the most efficient pace.

This transformation of a competitive advantage in earlier times to a mere hygiene requirement today has put immense pressure on Principal organizations to look for other opportunities to stay ahead of competition. On the other hand, service vendor organizations have also realized that it is no longer enough to provide efficiency driven services. They need to find ways and means to add managerial and/or technical value to stay ahead of competition in their vendor market space.

This paper attempts to provide a perspective about how much of such forward integration is possible for outsourced service providers given their competencies and the motivation of the client organization to encourage such trends. The assumption made is that forward integration for the outsourced supplier is the preferred route to provide value added services. Without any constraints, forward integration in the outsourcing context would lead to a complete absorption of the Principal by the Agent. In reality, there are limits to such integration, both physical and psychological, which this paper discusses.

1.0 Traditional Outsourcing Philosophy

Outsourcing has historically meant parsing out functions to entities beyond the perimeter of the principal organization for various purposes: 1) for reducing operational cost, 2) for reducing headcount, 3) to offset scarcity of resources in the principal domain or, 4) for buying specialized skills unavailable in the principal organization. The last motive is mostly linked to the necessity of incorporating a special skill from outside that may not be available within the organization. Usually, this type of outsourcing is of limited nature and is mostly related to value-added services purchased on an irregular basis within the Principal's operating domain.

The past fifteen years of steady integration (globalization) of the world economy has primarily addressed the first three objectives of outsourcing. The principal motivation of such an enterprise eventually is directed towards reducing the total operational cost of the value creation process. However, cost reduction has its limits. Many vendor organizations who have imbibed the spirit of efficiency management through the cost arbitrage route are now facing new challenges of ramping up their value delivery through providing newer services that add to the effectiveness of decision processes as against a traditional uni-dimensional focus on cost reduction¹.

Bhagwati et.al (2004) have explained the impact of outsourcing on the global economy primarily on the dimension of job loss in more affluent economies. On the whole, they have postulated that the global economy has progressed significantly despite the marginal job losses in the affluent countries. Similar postulation is available in other studies of a similar nature. However, many of these researches are focused on issues related to low end cost-centric outsourcing activities. No significant research has yet emerged in the area of value-based outsourcing where the cost parameter is secondary. The Mckinsey Global Institute (2005) research identifies three significant dimensions which can influence the nature of outsourcing activity in the global market:

- 1) The requirement for proximity to customers may limit the amount of off shore (international) activities.
- 2) The requirement for domain knowledge which resides mainly in “on site” locations may offset some of the advantages of outsourcing, especially in the context of off shore environment.
- 3) The complexity of the process can also dictate the (in)ability to outsource. Usually, processes that require multiple iterative transactions across functional teams are less amenable for off shoring (outsourcing).

Some of these physical parameters that provide constraints in outsourcing processes are to an extent mitigated over time with familiarity of managerial personnel across off and on shore sites and, also with improvement in communication channels. However, what is not so well established are the strategic dimensions that influence outsourcing activities and their impact in the future. In the next section we focus on value-added processes and their propensity to be outsourced. A business case is discussed to highlight the challenges in off shoring a relatively high end process.

2.0 The Domain of Value Creation and its Barriers

The motive of parsing out internal operations of the organization to external vendors is to extract the optimal value for the organization, either cheaper processing (due to high capital usage or lower labour costs) or, improved effectiveness of the process which leads to better quality of the finished product. The key parameter that governs the outsourcing decision is the trade-off between the incremental value obtained versus the downside of “loss of control” of the process to outside entities. Spencer (2005) provides a fairly comprehensive survey of the application of economic theory to model international outsourcing strategies.

However, like many traditional research in outsourcing, the paper focuses on outsourcing activities that derive cost efficiencies alone. Spencer (2005) and Suffredini (2003) also note that modeling the optimal outsourcing activity with related issues of sharing proprietary information may involve further complications of defining the “right” contract between the Principal and the Agent to ensure that the “control” dimension is not compromised.

¹ Observation based on informal survey in Gurgaon / Bangalore, India-based Organizations

Not much is available in the extant literature about the motivation of outsourcing higher end value-added services where cost advantages play a secondary role. The motivation to outsource value-added processes and the structural constraints in such activities require some extension of the model of traditional outsourcing.

The motivation for the vendor to climb up the value-creation chain is well known. The premium associated with value creation is significant enough to look at such opportunities seriously. However, it is unclear as to what may be the reasons for client organizations to accept such outsourcing arrangements, especially when many value creation processes are the differentiators for firms operating in a competitive environment.

Due to the unavailability of well researched literature in this area, we present below a case of value-added international off shoring activity in India and its performance in the initial years. Based on the information presented in the case, we will attempt to build a perspective of a model for value-added outsourcing.

2.1 A Case of Off shore Banking Operations in India

About 15-20 large global banks have made significant investments in back office operations in India in the past ten years. While the majority of the investment is in low end “voice” and “data” transactions, there have been some efforts at setting up higher end value added services such as financial and market analytics and equity research. Most of these operations employ trained graduates and post graduates and some doctorates in the field of science and social science and business management. Rough estimates provided by industry analysts show a market size of USD 300 million, employing about 10,000 personnel and increasing at the rate of 50% annually (Mishra, 2008).

What is recounted below is based on actual experience (experience/observation data) of setting up an operation in financial analytics for a global bank in Bangalore over a three year period. The author was significantly involved in setting up a 75-member back office analytics team to support the credit risk and marketing functions for a large consumer loans business in the United States. A few assumptions were made about back office modus operandi before the establishment of the team:

- 1) The purpose of setting up the team in India was to take advantage of the “enormous talent” easily available to run the operations.
- 2) The team was to be fully managed by the home office management since domain competency was entirely enshrined there.
- 3) The off shore team was to act as a support team for policy making and would provide its services in areas of its technical prowess. Business interpretation and implications on decision-making would be driven primarily by the home office (onsite) managers.
- 4) Functional responsibilities would be minimal as the offshore office was not expected to acquire any functional expertise in the medium term. However, it was recognized that clusters of responsibilities pertaining to “technological skills”, such as applications of statistics, mathematics and business programming, that could be undertaken independently in a remote location, would over a reasonable time be transferred to India. Policy making, on the other hand, would be almost impossible to transfer given the necessity of its proximity to the business domain.
- 5) Local administration in India would be restricted to maintaining hygiene work environment and compliance with local work laws.

Three years into the operation, and despite rapid expansion and increases in productivity, the team remains primarily a back office service provider of technical inputs (statistical modeling, forecasting and data enquiry) to the front office policy making process. Contributions to direct policy making are restricted to newer insights that indirectly feed into calibrating certain operational processes, but for most parts the responsibility set includes completing disparate tasks set up by front office managers. Local managers are primarily “people managers” and do not necessarily have functional responsibilities commensurate with their seniority in the organization. A significant portion of their responsibility has to do with facilitating smooth work flows across office and coordinating information/ communication gaps across team members based in offshore and onsite offices.

This operating model is based on the premise that offshore provides technical talent, whereas, the onsite management’s responsibility lies in bridging the business knowledge gap that exists in the offshore office; the latter is assumed to limit the usage of offshore resources for critical value-added work.

Other local operating managers at this particular offshore operation confirm that the back office value-add functions are more about running high end technical processes such as: developing statistical scoring models, forecasting losses, generating routine reports and performing ad hoc analysis; these activities have less to do with the actual function of developing or recommending credit policy measures and, are more about supporting such decision making with processed information from business data.

Other sources also revealed that a similar situation exists in all off shore units primarily because of two reasons:

- 1) No grassroots competence exists in the offshore domain on business functional responsibilities.
- 2) The premise of setting up the offshore operation was not on the availability of functional expertise, but cheap human resources with advanced technical skills.

While there is some debate in the KPO² industry on the need to provide end-to-end service to survive competitive pressures, on the whole this service industry remains highly fragmented and focused on specific tasks and activities rather than business solutions. Specifically on the analytics area, what is interesting is that the global analytics/ survey research market is valued at USD 10 Billion, but only 40% of it is operational enough to be outsourcable (Mishra, 2008). This is important enough as a fact to support the view that there may be limitations on how much of the business components can be outsourced.

3.0 A Conceptual Model for Outsourcing Value-Added Functions

The “on-the-ground” experience of operating managers in the particular off shoring business confirms that there may be tangible hurdles in transferring “effective” business processes to international outsourcing vendors. A common refrain heard is that offshoring will remain a back office support function for long, since it has ways to go before it is fully equipped with business domain knowledge to add value to the decision making process.

² Knowledge Process Outsourcing

A logical question that needs to be asked, why should onsite operations help scale up business domain knowledge to the extent that off shoring takes up critical functions? The following conceptual framework based on our experience may identify some of the dimensions that necessarily impact the rate of such built up. Hypotheses regarding their probable effect on the growth of value-added processes in off shore are provided.

We define a “Value-added outsourced” function on some or all of the following dimensions:

- a) The Process is considered by the Principal as critical for making business impact as measured by its direct impact on profits.
- b) The Process is not entirely replicable by the Principal’s nearest competitor and hence provides some competitive advantage.
- c) The Process involves a transfer cost which is considered to include a premium significantly higher than a cost-driven process.
- d) There are few outsourcing vendors who can replicate the operations of the Process like the specific outsourcing vendor being considered.

In determining the motivations for Principal organizations to outsource their value-added processes to Agent(s) the critical issue to be addressed is; why should Principals outsource such important processes which constitute their differential competitive advantage? The following dimensions emerge:

- 1) A source of relevant and critical expertise external to the organization (EXPERTISE)

An outsourced vendor may have knowledge/expertise which is unavailable internally and hence the Principal may seek such assistance in further enhancing its differential capabilities vis-à-vis the competition. Such circumstances prompt willingness to outsource high value added services to the service provider. A basic condition to be fulfilled for this relationship is whether the service provider has enough or more domain knowledge and expertise than the client.

- 2) The ability to “Ring Fence” the differential expertise obtained from the external source (LEAKAGE)

Both Spencer (2005) and Suffredini (2003) refer to the problem of drawing the perimeter around the propriety knowledge of the firm, with implications on dilution of control. Historically, research in the area of “Principal-Agent” theory have looked at the terms of the contract that minimize the “leakage” of proprietary expertise (Antràs 2003, Grossman and Hart 1986). Suffredini (2003) also mentions the impact of residual leakage, i.e., the “subliminal” transfer of broader expert knowledge to the industry. When the impact of such transfers is significantly adverse to the Principal, high end value outsourcing activities are discouraged. High-end management consultancies are vulnerable to perceptions of leaking such “residual” expertise industry-wide as a motivation to project themselves as broader subject matter experts.

- 3) The likelihood of parsing out a separate portfolio of tasks that can be handled independently with little inter team coordination (INDEPENDENT OPERATIONS)

This dimension is most likely to affect international outsourcing potential in high end value addition processes. Parsing out functions to outsourced vendors, especially in remote

locations suffer from the challenges of coordination across various multi-functional managers. In such complex problem solving situations, proximity of service providers to the decision maker is critical and often times non-negotiable. The Mckinsey Global Institute (2005) research mentions this dimension as a critical constraint in outsourcing activities.

4) Does it require proximity to the end customer? (PROXIMITY)

Many critical value added services require physical contact with the end consumption point (last mile issues). Such services are not amenable to international/remote outsourcing since physical distances cannot be compensated by equivalent communication technology. This dimension has been mentioned by the Mckinsey (2005) study as well.

5) Stability of the external environment at the international service provider domain (ENVIRONMENTAL STABILITY)

Mission critical high-end services require a stable operating environment, more so compared to low-end critical services. In the latter case contingency plans can be developed and redundancies can be built across multiple remote sites. However, the nature of high end services that provide differential advantage usually are not amenable to creating redundancies across the globe because cost would be high. Hence, such processes require tighter confidence band around environmental volatility to ensure that critical disruptions are avoided.

6) The possibility of obtaining a cost advantage (COST ADVANTAGE)

This dimension would be of secondary nature in the context of outsourcing critical business functions. However, all other effects being equal, low cost of delivery has its importance in deciding on where to outsource.

4.0 Traditional cost-based outsourced service vendor and their ability to deliver value-added services

The traditional North-South demarcation (Spencer, 2005) in cost-based outsourcing may dictate the perceived limits to which the high-end value servicing is possible in this business. For instance the tag of "SOUTH", hitherto an advantage in the cost arbitrage model, may pose a severe delimiter in building significantly relevant dimensions such as "EXPERTISE" and "ENVIRONMENTAL STABILITY" to facilitate high end international outsourcing. Traditional standards in the high-end service domain are spelt by "NORTH" based organizations, having leveraged their domain competency and technical expertise to provide high margin services (e.g., management consultancies such as Mckinsey).

While it may be early to make definitive conclusions, there appears to be a good chance that perceptions about "SOUTH" based countries and their lack of domain expertise may take sometime to erode. Till then, it seems that "COST ADVANTAGE" may be the predominant reason to outsource processes, thereby limiting the nature of activities that can be transitioned internationally. In fact, recent studies such as Rüdiger's (2007) have claimed that job losses in the OECD countries are estimated to be only about 20% due to international outsourcing. A primary reason for such estimate appears to be the inability of low cost countries such as

India to absorb higher potency work, mainly because of the lack of an environment that facilitates high growth of Knowledge-based products and services.

The implications of such a perspective can be significant. Giving their current perceived competencies, international outsourcing vendors, who are based mainly in low cost countries, may face a difficult task of scaling up the value chain in their businesses. The major challenge would be to overcome the Country-of-Origin effect (“SOUTH” brand), something that may take longer than it takes to meet the objectives on the capability front (Paswan and Sharma, 2004). Diluting the tag of a “SOUTH” image of the country may have a positive influence in this scaling up process. As Rüdiger (2007) points out, the consolidation of the western world’s relative strength in investment in human capital will ensure that international outsourcing of value-added jobs will be at best a slow process.

5.0 Directions for Future Research

This paper is perhaps a first attempt to identify the parameters that will govern the extent to which international outsourcing may absorb value-add services in the future. However, no quantifiable data exists to validate some of the claims that have been made in this paper. Our inferences are mostly based on our observation of the industry and the individual experience from the offshore domain. A good follow up on this conceptual model would be to validate the hypotheses with industry wide data on actual trends. The nascent nature of the outsourcing activity makes it impossible to gather elaborate quantitative data for any scientific analysis.

Additionally, the issue of “where can international outsourcing add value beyond cost arbitrage”, needs more specificity. While it is important to note that the opportunities to provide value are not limitless, it is also critical for industry experts to know where future investments ought to be made to sustain a viable offshoring/outsourcing business model.

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